Summary

This report, originally prepared as an annotated briefing, discusses the recommendations of the economics and business management literatures on issues related to outsourcing. These literatures emphasize that organizations have limited senior managerial time and financial resources to invest in maintaining efficient performance. Therefore, organizations should focus their efforts on those activities that can be most effectively managed internally, and outsource activities that can be more effectively managed externally. However, the same literatures highlight different issues for senior managers to consider in making outsourcing decisions.

In the economics literature, the paradigm of Transaction Cost Economics suggests that the organization of transactions between providers and users (e.g., organic vs. contractor) should be designed to maximize value net of the sum of production and transaction costs, based on the characteristics of the transactions. Transactions differ in asset specificity—the extent to which investments made to support particular transactions can be put to other uses if the buyer/seller relationship ends. Governance structures—markets, contracts, and internal hierarchies—differ in their incentives to maximize value net of costs and in their ability to protect investments in transaction-specific assets. For example, markets provide strong incentives to maximize net value, but little protection for transaction-specific investments, because it is easy for buyers or sellers to walk away from the relationship. Therefore, transactions that involve a high level of asset specificity can often be more effectively organized internally, since the organization has an incentive to protect its own investment in the transaction. Transactions using relatively generic assets can be outsourced more easily.

Statistical tests of transaction cost theory associate the observed pattern of governance structures with characteristics of transactions, including asset specificity based on location, technology, and human skills and knowledge. Using data from a variety of industries, these studies have generally shown results consistent with the theory. Their approach is based on “survivor analysis,” which argues that inefficient governance structures will be weeded out by competitive pressure, so the forms of organization observed in the private sector should be efficient. However, this is not necessarily true for government entities such as the Air Force, which do not face the same types of competitive pressures that private industry does. Thus, the Air Force may be able to learn
from private-sector experience about the organization of transactions. For example, if the Air Force has tended to use organic provision when contractor provision could result in better performance net of production and transaction costs, then outsourcing would improve efficiency in some areas.

An extensive business management literature on outsourcing has grown as firms have shifted their organizational strategies away from diversification in favor of focusing on core competencies. Core competencies are defined as activities central to the organization’s mission, in which the organization excels relative to its competitors. Activities that are not core competencies should be considered for outsourcing or competition with external providers, particularly if external providers give the organization access to world-class performance. The business management literature focuses attention on the process of outsourcing, including source selection, contract design, and post-contract management. It emphasizes that cost reduction should not be the primary goal of outsourcing. Other benefits include improved strategic focus, better performance (such as more frequent deliveries or higher quality), accelerating re-engineering, and sharing risks with the supplier. To achieve these gains, organizations need to foster long-term relationships with suppliers of complex products or services, with whom they should share the benefits of improved performance.

The empirical side of the business management literature is largely based on case studies of vertical integration (i.e., internal provision of inputs or services), strategic alliances between organizations, and buyer/supplier relationships. Studies find that vertical integration is associated with transaction-specific assets and core competencies, but it is less likely when there is a high degree of uncertainty about demand or technology, or if the organization already has substantial bargaining power over its customers or suppliers. Strategic alliances are also likely to be less structured and more independent of their parent organizations when there is greater uncertainty. The literature on buyer/supplier relationships originated with comparisons between the U.S. and Japanese automobile manufacturers, but has been extended to a wide range of industries, including electronics, office equipment, and aerospace. This literature suggests that long-term partnerships between buyers and suppliers of complex goods and services can improve performance and lower costs, because partnerships promote investment in transaction-specific assets while preserving market-like incentives to maximize value net of costs.

Although the economics and business management literatures differ in the issues they emphasize, their recommendations are complementary rather than contradictory. Given the centrality of core competencies to an organization’s mission, and the high transaction costs of contracting for services when asset
specificity is involved, it seems prudent that the Air Force should focus its outsourcing efforts on activities that neither are core competencies nor involve high degrees of asset specificity. However, the business management literature suggests that the Air Force could outsource activities involving asset specificity, such as the provision of complex services, if it develops longer-term partnerships with these suppliers rather than treating them as arm’s-length vendors. Acquisition reform is encouraging greater use of information on contractor past performance in source selection, which could be extended to outsourcing efforts for complex support services. By rewarding good performers with future business, the use of past performance information could help develop longer-term relationships and encourage transaction-specific investments.